Testimony of

James Chessen

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

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Before the

Subcommittee on Economic Development,

Public Buildings and Emergency Management

Of the

Committee on Transportation and Infrastructure

United States House of Representatives

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Madam Chairwoman and members of the Subcommittee, my name is James Chessen. I am the chief economist of the American Bankers Association (ABA). ABA brings together banks of all sizes and charters into one association, and works to enhance the competitiveness of the nation's banking industry and to strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.3 trillion in assets and employ over 2 million men and women.

ABA appreciates the opportunity to testify today on the current state of funding for commercial real estate, including properties leased by the federal government. It is a very timely topic as our nation is certainly facing difficult economic conditions which are affecting all businesses, including banks. In spite of the difficulties, I want to say at the outset that I am very positive about our nation's economic future. We have gone through these periods before and have emerged much stronger as a result.

One very basic point, however, should be stressed – the core business of banking is lending. That is what banks do. Banks will continue to be the source of financial strength in their communities by meeting the financial needs of businesses and individuals in both good times and bad. In fact, at a recent meeting of bankers representing every state in the country, they made it clear that banks are actively looking for good loan opportunities. Even in a weak economy, there are strong borrowers, including developers and owners of government leased property, that merit bank funding.

I am also very positive about the banking industry. Before turning to my main points, I know that many committee members may be wondering about the health of the banking industry in light of the several recent bank failures. These well-publicized failures have led to headlines and news stories, some of which seem designed more to grab attention rather than to lay the facts out fully, clearly, and in context. Let me assure you that the industry remains fundamentally strong. Banks entered this current period with a very strong capital position and have continued to build capital over the last several quarters. In fact, the industry added $13.5 billion to capital in the first quarter – which increased the total capital of the industry to well over $1.3 trillion – and banks have set aside an additional $121 billion in reserves as a safeguard against possible losses. Moreover, as of the first quarter, 99 percent of banks are classified by the regulators as "well-capitalized," the highest designation given by the banking regulators. Simply put, the industry has the capital and reserves to continue to make the loans that are so vital to our communities.

In my statement today, I'd like to make three points:

- Commercial real estate lending has been and will continue to be a primary focus of banks, and banks will continue to be very supportive of loans to developers and builders involved with government building and leases;
- Banks are naturally being more cautious in the face of weak economic conditions, but are continuing to lend to creditworthy customers; and
- Over-zealous bank regulations pose the greatest risk that a credit caution will turn into a credit crunch that will affect all commercial real estate lending in particular and the economy in general.

I. Commercial Real Estate Lending Has Been and Will Continue to Be a Primary Focus of Banks

Commercial real estate lending represents a wide variety of lending, differing in purpose, structure, and terms. Commercial real estate lending – including loans to developers and builders involved with government building and leases – has always been an important lending area for banks. It is a lending focus where banking expertise has played a particularly important role for economic growth in our communities. Banks today finance more than 50 percent of commercial real estate debt outstanding. Since the late 1990s, banks have steadily increased the share of total assets devoted to commercial real estate, tailoring new and existing services to meet the individuals needs of borrowers and our communities. Commercial real estate lending requires a high-touch strategy with borrowers and extensive knowledge of local markets.

Within the broad category of commercial real estate lending, the construction and development portion has shown the most dramatic changes over the last decade, rising then falling twice, first with the dot-com boom and bust and more recently with the last build-bust housing cycle. This recent downturn has meant that there are more builders, developers and owners of commercial real estate who are late in repaying their loans and banks have been forced to write off many of these loans as losses. While banks are willing and eager to work with distressed borrowers to resolve loan problems, prudential management concerns also require us to be active in recognizing losses when such resolutions are not possible. Current delinquencies and losses have focused considerable regulatory attention on the economic viability of any new construction and development projects, whether for residential or commercial properties. Such increased regulatory focus is appropriate where it results in improving underwriting standards; it becomes harmful when it prevents banks from providing or continuing financing to creditworthy borrowers.

II. Banks are Naturally Being More Cautious, But Continue to Lend

Like all specialized forms of lending, loans for the construction, development, and long-term funding of government leased property have unique elements. The long-term nature of government leases and the high credit quality of government tenants make loans to build and support such properties very attractive to lenders. There are certainly risks to be considered, however: the procurement process, special covenants in government contracts, restrictions on covering unexpected increases in operating expenses (such as the recent surge in energy prices), protection of collateral if the government refuses to vacate property at the end of the lease or condemns it, and added costs of special security features (which may not be considered an integral part of the initial economic calculation by the developer or fully amortized as part of the lease or loan facility), among others. All of these add risk to borrowers and must be considered by the bank in making loans available and pricing them correctly.

These unique features are factors that exist ***regardless*** of the economic cycle. The current economic situation adds an extra element that affects the availability and price of credit, in spite of the fact that the demand for government services is somewhat immune from, and often countercyclical to, the general business cycle. Against the backdrop of a very weak economy, it is only reasonable and prudent that all businesses – including banks – exercise caution in taking on new financial obligations. Both banks and their regulators are understandably more cautious in today's environment. Bankers are asking more questions of their borrowers, and regulators are asking more questions of the banks they examine. This means that some higher-risk projects that might have been funded when the economy was stronger may not find funding today.

In this environment, we sometimes hear from individual businesses and developers that banks are not lending money. While overall bank lending continues to grow, that does not mean much to an individual borrower having difficulty obtaining financing. In many of these individual cases, however, upon further investigation, it appears that the primary reasons for not receiving funding was either (a) the borrower's financial condition is vulnerable (perhaps weakened by local economic conditions), or (b) the borrower expects to borrow money at pre-2008 terms when the risk of lending was considerably lower and funds available for lending were more accessible. One thing that has clearly happened is that banks are looking at the risk of a loan and re-evaluating the proper pricing of that risk. This is a prudent business practice and one expected by our bank regulators.

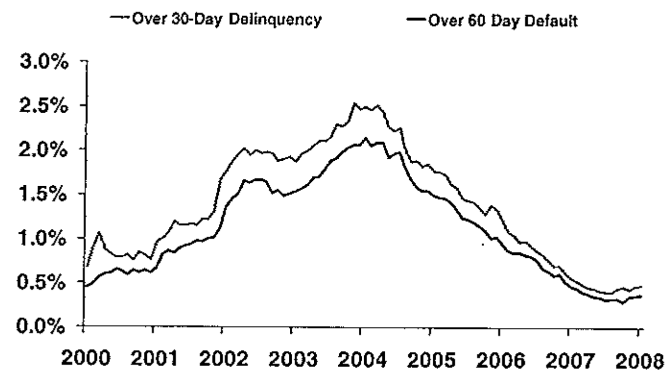
Any evaluation of the risk of any lending for government-leased properties must consider the market for office space as a whole. Thus, changes in the supply of and demand for office space generally would be considered in evaluating the overall risk of any project. We have now witnessed three consecutive quarters of rising office vacancies nationwide – consistent with a sluggish economy and job losses, particularly in areas that have higher concentrations of housing market problems. In this environment, banks are using more conservative assumptions on absorption of office space, rent growth and price appreciation.

In the Washington, D.C. region, construction of government properties is particularly important. It is also, of course, experiencing declining home values and rising office vacancy rates. For example, Colliers International reports that as of June 30, 2008, the office vacancy rate (for all classes of property) in downtown Washington, D.C. increased to 7.9 percent from 7.6 percent at the end of March. This does compare favorably to the average vacancy rate of 11.3 percent among central business districts that Colliers International tracks. This level is also below the suburban Maryland and Virginia vacancy rates, which increased from 10.4 percent to 10.7 percent and from 11.1 percent to 12.2 percent, respectively, over the same period. The national suburban office vacancy rate was 14.2 percent. Nevertheless, it is very important to note that the current office properties under construction in downtown Washington, D.C. – 9.1 million square feet – represents nearly ***19 percent*** of all downtown office construction in the 56 major metropolitan areas that

Colliers International tracks. This may lead to greater vacancy rates in the future as these properties come on line.

Another important factor affecting the volume of commercial real estate lending is the ability of banks to sell loans on the secondary market. Unfortunately, this market has been a victim of the housing market fallout. Even though few problems were apparent in commercial real estate loans, investors reacted to the problems in the residential mortgage-backed securities market and shunned new commercial mortgage backed securities (CMBS) or demanded higher risk premiums. This problem was exacerbated by mark-to-market accounting rules that pushed down the value of existing investments in these loans as market prices declined, which greatly undermined interest in this investment category. In fact, there was no new issuance of CMBS in January 2008, the first such occurrence in any month in the 20 years since the CMBS market began. This has dramatically affected the funding and cost for new loans for construction and development projects and other commercial real estate loans. It is particularly troubling that the adverse market reaction is at odds with the historical performance of CMBS loans (see the charts above). While the market will surely regain its footing, it will continue to affect how risk is priced for commercial real estate loans for some time to come.

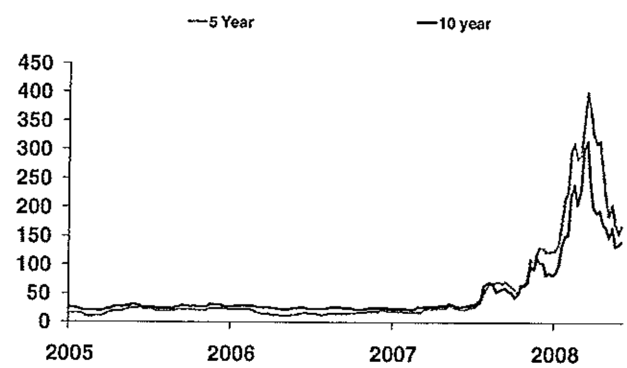
CMBS Delinquency and Default Rates



Source: Wachovia and Commercial Mortgage Alert

5 and 10 year AAA CMBS Spreads

Basis Points



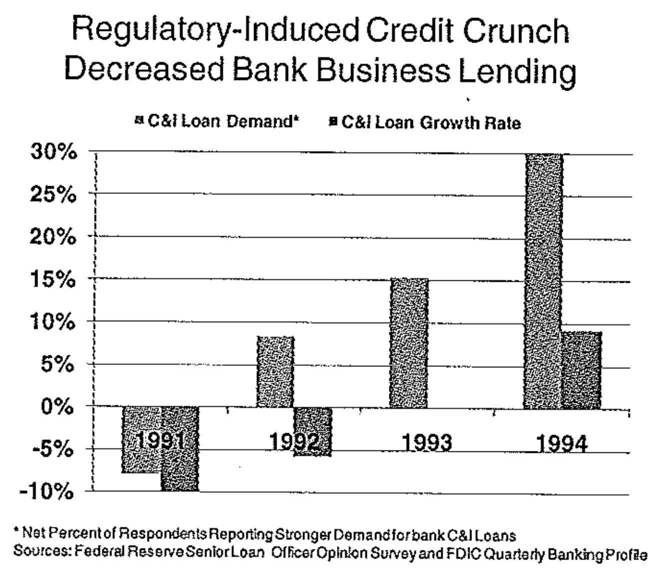
Source: Wachovia and Commercial Mortgage Alert

The weak economy and lack of secondary market funding will naturally slow the growth of commercial real estate lending. However, as many of these projects take years to develop and because there is still strong underlying demand in many metropolitan areas, credit continues to grow. According to estimates by the ABA's Economic Advisory Committee, lending to businesses will increase 15 percent this year and fall off to 7.8 percent next year in line with the slowing economy. Moreover, commercial mortgage borrowing has also been quite strong, in spite of the misperception by some that banks have severely reduced their lending on commercial real estate. According to the Federal Reserve's Flow of Funds data, net commercial mortgage borrowing from banks for the first quarter, was on an annualized pace of $135 billion – $17 billion more than reported in 2007. If this pace holds, it will be the second largest increase, only exceeded by $143 billion in net commercial mortgages in 2006. Simply put, while banks are naturally more cautious in this economic environment, they still continue to seek out good loans as we invest in the future of our communities.

III. Over-zealous Bank Regulations Pose the Greatest Risk for a Credit Crunch

The current regulatory environment is unquestionably impacted by the regulatory concerns flowing from the housing market downturn. A natural reaction is to intensify the scrutiny of commercial banks' lending practices. However, we are very concerned that a regulatory over-reaction can quickly convert a credit caution into a credit crunch.

One needs only to look back at the early 1990s to see what can happen when there is a regulatory over-reaction to an economic recession with roots in residential and commercial real estate problems. At that time, whether intended or not, the loud and clear message that bankers received from the regulators and Congress was that only minimal levels of lending risk would be tolerated. On the surface, this might have seemed reasonable – there is little doubt that economic consequences of a banking system with too much risk are not acceptable. But just as too much risk is undesirable, a regulatory policy that discourages banks from making good loans to creditworthy borrowers also has serious economic consequences. Wringing out the risk from bank loan portfolios means that fewer loans will be made, and that only the very best credits will be funded.



The regulatory over-reaction in the early 1990s led to a credit crunch, as lending declined significantly. In spite of rising demand for bank loans following the recession of 1991, regulatory pressures restrained bank lending. In fact, total bank loans actually declined throughout this period and the recovery was slower than it might have been (see the chart above). The regulatory-induced credit crunch was confirmed by academic work on the New England economy by Eric Rosengren (now the President of the Federal Reserve Bank of Boston) and Joe Peek (now the Gatton International Banking Chair, University of Kentucky) in their paper "Bank Regulation and the Credit Crunch." The authors concluded that: "Because so many bank loans are generated locally, and because informational and regulatory impediments deter the transfer of bank capital and credit across regions, our evidence suggests that New England did suffer from a regulatory-induced credit crunch."[1]

A comparable scenario may be developing in today's regulatory environment. Accounting rules and excessive regulatory demands are acting together to limit the ability of banks to make loans and in some cases to continue existing funding arrangements. For example, one of the major concerns of the industry is the prospect of bank examiners appraising banks into insolvency. This could occur from a number of interrelated causes. For example, we hear reports from our bankers of examiners demanding that banks obtain new appraisals on properties for fully performing loans, i.e., loans where the borrowers are current and meeting their obligations to the bank. Given existing market prices, it is not surprising to find that values are down, so that such appraisals could result in banks having to downgrade fully performing loans as being in some degree troubled, what many refer to as "non-performing performing loans." Together, the revaluations and downgrades discourage banks from lending for similar projects.

In other instances, we hear of examiners forcing banks to mark the value of collateral to current market values even though there is little expectation that the bank will be relying on the collateral for repayment of the loan. As these asset mark-downs are reflected on a bank's books, the bank's capital is reduced. A bank can reach the point (as many did in the 1980s and 1990s) where such actions significantly impair capital, reducing bank resources available to fund new loans. Thus, taking a snapshot of a bank's assets during the low point of an economic cycle and forcing the bank to reflect the worst-case scenario on its books runs the risk of bringing about the very consequences that the banks and their examiners are trying to prevent – causing the bank to retrench, reducing banking lending overall. To avoid this outcome, we have been urging the regulators to keep in mind that markets are cyclical and that not every worst-case scenario will occur if the market is left to function without inappropriately restrictive intervention.

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[1] Peek, Joe, and Rosengren, Eric. "Bank Regulation and the Credit Crunch," February 1993, Working Paper No. 93-2, Federal Reserve Bank of Boston.

Fortunately, bank agency heads seem to be sensitive to this potential problem and have pledged to avoid a repeat of the early 1990s. For example, John Dugan, Comptroller of the Currency stated in April that: "At the OCC, we know that we made some mistakes during the last downturn. ... One of the most controversial issues associated with the last real estate downturn was the tendency for OCC examiners to make unilateral adjustments to real estate appraisals that had become outdated due to clear changes in the markets. We want to minimize the use of this approach during the current cycle."[2] This sentiment was also echoed by Sheila Bair, chairman of the Federal Deposit Insurance Corporation: "...the bottom-line purpose of the guidance [on commercial real estate lending] is to simply remind bankers that their risk management practices need to keep pace with increasing exposures to commercial real estate and construction activity. We do not intend to disrupt or limit the volume of commercial real estate lending that is prudently underwritten and well managed, nor should the guidance be interpreted as supporting a reduction in the current volume."[3]

The great challenge may be to ensure that the measured approach expressed by agency leadership is being applied by regulatory personnel out in the field. Increasingly, we are hearing troubling reports from our membership that regulatory mistakes of a decade ago are playing out again today. What the regulators want for the industry is what the industry wants for itself: the maintenance of a strong and safe banking system. To achieve that goal, we need to remember the vital role played by good lending in restoring economic growth and not allow a credit crunch to stifle economic recovery.

Thank you again, Madam Chairwoman, for the opportunity to present the views of the American Bankers Association in this hearing today.

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[2] Remarks by John C. Dugan, Comptroller of the Currency, before the Exchequer Club, Washington, D.C., April 16, 2008

[3] Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation before the California Bank Presidents Seminar, Santa Barbara, Calif., January 12, 2007